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43210

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The Economics of Loans to Informal Groups of Small Farmers in Low Income Countries

by

Dale W Adams

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Agricultural Finance Program
Department of Agricultural Economics and Rural Sociology
The Ohio State University
2120 Fyffe Road
Columbus, Ohio 43210

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The past few years a number of low income countries have attempted to increase the loans made to agriculture in general and to small farmers in particular. These efforts have been morally and financially supported by various international banks and aid agencies [7].** A variety of strategies have been used, especially in attempts to increase the amount of loans made to small farmers. These include massive increases in the overall credit available, with the hope that some would filter down to the rural poor. Recent examples of this strategy are Brazil and Thailand. Another popular technique has been to place various loan portfolio restrictions on lenders in order to force more lending to small farmers, the Philippines and the Dominican Republic being examples. Many countries have also used concessionary rediscount rates on central bank facilities or loan guarantees as ways of inducing more lending to small farmers. Creating new, specialized credit institutions or programs exclusively to service small farmers has also been popular. Numerous supervised credit programs in Latin America and small farmer credit programs in India are examples of this approach.

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* Professor of Agricultural Economics, The Ohio State University.

** Refers to citations listed at the end of the paper under References.

Although expansion in lending to small farmers has occurred in a few countries, the overall results from these various strategies have been disappointing. In a few countries the purchasing power of the total formal loans going to small farmers have declined, not increased. Many of the administrative fiats aimed at forcing lenders to lend to small farmers have been ignored or their original interest evaded. Careful analysis of small farmer credit programs or agencies several years after their initiation often shows they are essentially bankrupt, that they are heavily dependent on government subsidies, or that they are no longer serving primarily small farmers. These problems have been accompanied, in some cases, by loan repayment difficulties.

A number of lenders have found that loans to borrowers of small amounts are costly, that many of these borrowers have unsatisfactory loan collateral, and that too many of these small loans are not repaid. It also appears that some potential small borrowers have been discouraged from seeking loans because of the time, effort and costs associated with transacting a formal loan. In most cases both supply and demand problems are impeding the flow of loans to small farmers.

In attempts to overcome some of these problems, formal lenders in a number of countries have been experimenting with making loans to informal groups of small farmers [4]. In a few countries like Thailand, Mexico, Ghana, Chile, and the Philippines, a large part of the formal loans going to small farmers moves through these informal groups [5, 9, 10, 12]. In other countries like Malawi, the Dominican Republic, and Bolivia, group lending is done more on a pilot project basis [1]. Several countries such as Turkey and Japan have had experience with group lending which goes back a number of decades. Other countries like Bangladesh (The Uttara Bank) and Sri Lanka are just beginning to experiment with this technique.

At least four economic advantages are claimed for group lending: (1) lender loan transaction costs are reduced, (2) joint liability for the loan causes internal group pressure for repayment and thus reduces defaults, (3) borrowing through a group reduces the average borrower's loan transaction costs, and (4) the group can be used as an efficient way of introducing other productive services such as extension and technical training.

In many cases non-economic goals are also sought through these groups. Informal credit programs in some countries are stepping stones; organizers view them as pre-cooperatives which might evolve into formal cooperatives. In other cases the groups are used to make members socially and politically active. Through group action, organizers hope to induce changes in the way participants view themselves and also force changes in organizations which might provide services to the rural poor [8]. Since very little careful analysis of the results of group lending has been done, the discussion which follows is quite conjectural. Emphasis is placed on classifying the major issues and on trying to ask the right questions rather than giving hard and fast answers. Two major questions are addressed. First, how can viable groups be formed or strengthened? Second, what role can group loans play in improving financial services available for the rural poor?

Organizing Groups

Three general approaches have been used to form credit groups. At one extreme, a small number of potential borrowers from a single lender have been hurriedly drawn together for the sole purpose of getting a group loan [9]. At the other extreme, organizers of groups may spend many months or even several years helping to evolve viable groups which then begin to borrow collectively [3, 13, 14]. Still another approach has been to use groups formed earlier by some other agency, or to use groups which have existed for some time for other purposes, as a basis for group lending.

Most people who have worked in organizing these groups readily admit there is more art than science in their efforts. It appears, however, that at least five conditions must be met if group action is to be elicited successfully [6, 11]. First, individuals who engage in group action usually do so for selfish reasons. They must realize some organizational good. That is, they must get some good, service or satisfaction through the group which could not be obtained individually at reasonable costs. Second, if the group activities include productive goods or services the individual must be able to convert these into profitable investments. The net returns on these activities must be competitive with other activities which the participant can do individually. The net returns must also compensate the participant for the loss of individual discretion involved in being a member of a group, and also the individual costs of maintaining group membership.

Third, viable groups must provide more or less equal access to all members to the organizational good. It is difficult, for example, to maintain a credit group if only the leaders of the group have access to the concessionary credit. Fourth, the optimum size of a group will depend largely on the purposes of the group. The larger the group, the more difficult it is to maintain a common interest. And, the larger the group the easier it is to have a factional takeover. Fifth, for groups to have longevity they must have political acceptance. This may mean legal recognition or simply political support for the formation and existence of groups.

Too little research has been done on group organization to draw a blueprint for their construction. Information from several countries strongly suggests, however, that groups solely formed to gain access to concessionary credit do not work very well. An elete faction often captures most of the "sweet money" for themselves.

Role of Groups in Financial Intermediation

The primary justification for forming credit groups varies across countries. In some cases groups are viewed as a way of reducing the lender's transaction costs for making small loans. In other cases the groups are mainly used to try and increase rates of loan repayment through some joint liability or peer pressure. Still other groups are formed to achieve a variety of purposes only one of which is to provide financial services to the rural poor.

Lender Transaction Costs

Lenders incur four types of costs in making loans. These are: (1) the expenses of acquiring the funds which are lent, (2) the transaction costs of making and administering the loan, (3) the losses incurred when some loans are not repaid, and (4) profits or economic surpluses needed to pay owners of the financial institutions. When small loans are involved, the loan transaction costs are a very important part of the lender's total cost considerations. For most formal lenders the transaction costs per unit of money lent varies inversely with the size of the loan. Transaction costs are essentially the same regardless of the size of loan. Lenders do, however, experience substantial differences in loan transaction costs between loans to customers of long standing and new borrowers. It is often costly for a lender to assemble sufficient information to assign a reliable repayment probability to a new borrower. Thus, other things being equal, individual loans to new small borrowers are doubly undesirable for most formal lenders.

Potentially, making loans to groups of new small borrowers should sharply reduce the lender's loan transaction costs per unit of money lent, when compared to small individual loans. This assumes, of course, that the lender does not have to incur substantial promotional costs to help form the group and introduce the group to the procedures for getting formal loans. Group lending may or may not help to reduce the lender's costs of establishing the new borrower's repayment potential. If the group has a track record in other successful activities, the lender may be able to conclude rather quickly that there is enough group cohesion to assure loan repayment. On the other hand, if the group is new, the lenders may be saddled with doubts about the viability of the group as well as with doubts about the capacity and willingness of members to repay loans.

Improving Repayment

A number of group lending programs are aimed at improving loan repayment performance. There are at least four ways in which groups might work to improve repayment. First, group members may be held jointly liable for repaying the loan. If one member does not repay, other members are obligated to cover the entire debt. Second, groups may be cohesive enough so that group pressure is placed on members who are slow to repay. Third, some of the group's activities may include marketing a major part of the produce of its members. If this is the case, the group may be able to assure repayment by withholding part of the proceeds from sales to cover debt repayment. Fourth, the group may be forced to pledge as loan collateral some asset which they jointly own. An innovative World Bank project in Malawi uses this technique. In this project, group members are forced to deposit with the lending agency 20 percent of the value of their total group loan in a blocked, group savings account. If the group fully repays its loan, the savings plus interest are returned to the group. Shortfalls in repayment are deducted from the deposit.

The actual repayment record in group lending is mixed. Programs in Malawi, Mexico (Puebla), and the Dominican Republic appear to have very satisfactory repayment records [2, 5]. Repayment results in the Philippines and Ghana, on the other hand, have been much less satisfactory [9, 12]. At least in the Philippines, group lending appears to have had no positive effect on repayment performance. In many credit groups in the Philippines there has been almost no peer group pressure applied on members to repay. In some cases, if one member of the group has been unwilling or unable to repay, the entire group has refused to pay.

The factors which cause some groups to be successful in improving loan repayment while other groups are unsuccessful are not clearly understood. The following factors, however, appear to be positively associated with successful groups: (1) groups which borrow short-term do better in repaying than groups which borrow long-term, (2) groups organized just to get credit do not perform as well as multipurpose groups, (3) groups made up of relatively homogeneous members perform better than groups which are highly stratified, (4) group loans made for a single enterprise or crop are more often repaid than multi-purpose loans, (5) loans to groups of individuals who have some solidarity before formal grouping are quite often repaid, and (6) group loans made by well administered organizations are more often repaid than loans made by badly run financial institutions.

In a few cases it appears that loan repayment is low because the quality of the financial services provided to the group are poor or very unpredictable. The services may be so poor that the individual borrowers feel the benefits from keeping the borrowed money are greater than the cost associated with loss of a good credit rating.

Borrower's Loan Transaction Costs

Transacting loans involve costs for both the lender and the borrower. The lender's transaction costs are well understood, but very little attention has been given to the importance of non-interest, loan transaction costs incurred by the borrower. These borrower costs include work time lost in order to negotiate the loan, travel costs to visit the lender, loan paperwork costs, and in some cases, bribes to speed the loan application process.

Typically, new borrowers find their loan transaction costs are much higher than experienced borrowers. In some cases formal lenders shift part of their normal loan transaction costs to the borrower, or artificially raise the borrower's loan transaction costs through delays and forcing the borrower to make many visits to the lender. This tactic is used when lenders want to discourage certain kinds of unprofitable lending without taking overt actions.

In theory, at least, group lending should reduce the borrower's loan transaction costs. Ideally, only a couple of the members of the group should find it necessary to visit the lender to negotiate the loan. A few innovative lenders have even developed mobile banking services which bring the "bank" to the borrowers on a regular basis. Some lenders also arrange for inputs, purchased with the loan, to be delivered in bulk to the borrowing group. This further reduces the borrower's costs of acquiring these inputs. These reductions in borrower's costs make the loan more valuable to the borrower, and also stimulate loan demand.

In practice, some group lending does not appear to substantially reduce borrower's loan transaction costs. Some lenders, at least in the Philippines, force each borrower to visit the bank to sign forms. In other cases, borrowers may view attending periodic compulsory group meetings as a part of their loan transaction costs. Forced savings programs which do not include satisfactory returns on savings deposits may also be viewed by borrowers as part of their costs of getting a group loan. As mentioned earlier, loss of some individual liberties under a group loan may also be viewed as a cost of getting a group loan. The possibilities of being held liable for someone else's unpaid debt may also be viewed as a cost of using group credit. If these expected costs are substantial, one should not be surprised to see individuals drop out of group lending programs, even when concessionary interest rates are involved. Inexpensive credit may not be cheap if additional borrower loan transaction costs are substantial.

Non-Loan Purposes

A final economic justification for forming groups is that other complementary productive services, besides loans, can be more efficiently provided to groups than to individuals. The group can be used as a way to introduce new technology or improved production practices; extension agents can share their information in group meetings. It might also be possible for the group to carry out some land preparation, land improvement, or marketing activity which would be less efficiently done individually. Unfortunately, very little research has been done on these issues and little can be said about their relative importance. Some research done in the Philippines, Bolivia and the Dominican Republic, however, suggests that the technical education which accompanies most group loans is not very useful nor is it very effective.

CONCLUSION

There is too little information available to allow informed judgements about the effectivenss of group loans in providing financial services to the rural poor. Recently completed research in the Philippines, and research underway in Thailand, Bolivia and the Dominican Republic should allow the drawing of some generalization in the near future.

If group lending does not prove to be an effective way of reducing both lender and borrower loan transaction costs and also improving loan repayment, some other major innovation will be needed to help provide financial services to the rural poor in low income countries.

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